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RUEATRS/DEPT OF TREASURY WASHINGTON DC  
INFO RUCPDO/DEPT OF COMMERCE WASHDC  
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UNCLAS SECTION 01 OF 05 JAKARTA 006120

SIPDIS

FROM AMCONSUL SURABAYA 1303

DEPT FOR EAP/MTS AND EB/IFD/OMA  
TREASURY FOR IA-JEWELL  
COMMERCE FOR 4430-GOLIKE  
DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO

SENSITIVE  
SIPDIS

E.O. 12958: N/A

TAGS: [EFIN](#) [EINV](#) [ECON](#) [PGOV](#) [ID](#)

SUBJECT: Indonesia: East Java Banks' Conservatism Causing  
Credit Contraction

Ref: A. Jakarta 1833 - Banking Sector Update

[1](#)B. Jakarta 3244 - Sharia Banking

[1](#)1. (SBU) SUMMARY: East Java accounts for 15 percent of Indonesia's GDP, 20 percent of total population and is an important industrial and manufacturing center in Indonesia. Credit contraction, increasing non-performing loans (NPLs) and declining inflation, implying demand reductions, are slowing the local economy and causing concern for East Java Banking officials. Credit contraction is counter to the Bank Indonesia's national credit expansion objectives for 2006 in support of its 5.0 to 5.7 percent national growth goals. Bank of Indonesia Surabaya (BIS) officials are pressuring local bankers to ease credit and grow loan portfolios faster. Risk-adverse East Java headquartered banks are committed to maintaining credit discipline even though loanable funds are expanding due to increasing deposits. Rural credit banks are reeling from the slowing economy and increased competition. Higher interest rates have also slowed growth in East Java sharia banking. BIS seems to exert little influence on local bank lending behavior and practices. East Java bankers believe that the recent 25 basis point reduction in Bank Indonesia base rate will have little or no impact on stimulating the economy. If East Java bank behavior is indicative of the rest of Indonesian banks; Bank Indonesia will need to look at other tools, like further base interest rate reductions, to stimulate growth. END SUMMARY.

East Java Credit Crunch  
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[1](#)2. (SBU) In an April 21 meeting with ConGen Surabaya Econoff Williams, Bank Indonesia - Surabaya Branch Office (BIS) officials initially asserted that as of February 2006, credit in East Java was growing at 23 percent per annum and loan growth was on track to meet 2006 expectations. After reanalyzing their own closely held monthly statistics, they discovered that total credit held by all banks in East Java had actually contracted by 2.5

percent over the first two months of 2006 (15 percent annualized). Officials were also worried that banks headquartered in East Java had reduced loan portfolios by 3.6 percent (21.6 percent annualized) over the same period. (Note: Total credit grew in East Java by over 27 percent during 2005. End Note.) Credit contraction is counter to the Bank Indonesia's (BI) national stated objective of 20 percent credit expansion for 2006 in support of its 5.0 to 5.7 percent national growth projections. BIS officials stated earlier this year that they had made "suggestions" to local banks that 20 percent credit growth was the magic number, and they had expected that level of loan growth or greater from the East Java banks. BIS officials said they would be having "additional discussions" with East Java banks regarding local loan growth performance, implying they will pressure local banks to ease credit.

#### NPLs on the Rise

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13. (SBU) BIS also noted that NPLs for all banks in East Java increased by 16.4 percent (from 5.5 to 6.4 percent) during the first two months of 2006. NPLs for East Java headquartered banks grew by 25 percent (from a very low 1.0 percent to 1.25 percent) at the end of February. According to Bambang Pramasudi, Deputy Head of Bank Supervision at BIS, East Java bankers are complaining of a worsening economy. Durable goods sales continue to decline due to higher interest rates and lower disposable incomes following fuel price increases in October 2005. Pramasudi was surprised that the East Java economy is not responding to positive macroeconomic indicators. "Interest rates are stable, inflation is low, the rupiah is strong and the stock market is up. But business in East Java is still

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slowing and even some good customers are paying slowly now. The slowdown seems to be impacting all levels of the economy here", Pramasudi commented. (Note: Two ConGen contacts recently reported closing furniture factories making export goods in East Java, laying off hundreds of employees, due to unavailability of local raw materials and the recent strengthening of the rupiah wiping out profit margins.) Following national trends, inflation in East Java declined from an annualized rate of 18.72 percent in January 2006 to 4.32 percent annualized in March 2006, reflecting reported decreases in regional demand. While the credit contraction itself is enough to cause concern, BIS officials' lack of awareness of provincial economic trends is worrisome at a time when the private sector is pessimistic about local economic performance.

#### Background on East Java Banking

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14. (SBU) East Java is considered an economic engine for Indonesia with almost 20 percent of the total population and a high concentration of Indonesia's heavy industry. According to a recent Bank Indonesia internal report, all East Java banks hold 11 percent of all bank loans and 13 percent of total assets in Indonesian banks. In addition to the Jakarta-based national banks with branches in East Java, there are approximately 370 banks of varying sizes headquartered in East Java. BIS is responsible for regulating all banks headquartered in East Java, as well as those in Bali, West Nusa Tenggara and East Nusa Tenggara provinces.

#### Surabaya Commercial Banks A Tight Bunch

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15. (SBU) Nine of the approximately 370 East Java-based banks are, or will be, large enough with capitalization over USD 9 million to be considered core commercial banks (CCBs) under the Indonesian Banking Architecture law (API) i.e. with capitalization over IDR 80 billion (USD 9

million). The remainder are small, privately owned, rural credit banks (BPRs) with capitalization under IDR 10 billion (USD 1.15 million). Under the API, banks with capitalization between IDR 10 billion and 80 billion (USD 1.15 - 9 million) are targeted to be closed or merged with larger banks by the end of 2007. Five of the nine Surabaya based CCBs are currently capitalized under the IDR 80 billion minimum. All five banks have submitted plans to increase their capital above the minimum requirement before the year end 2007 deadline.

16. (SBU) Local ethnic Chinese Indonesian business families own all nine of Surabaya's CCBs. By far the largest of East Java based CCBs is Bank Maspion, controlled by Alim Markus, President and Managing Director of the Maspion Group, Indonesia's largest domestic houseware manufacturer. Bank Maspion has total assets of approximately IDR 1.75 trillion (USD 200 million), NPLs under 2 percent and services primarily small and medium sized businesses. "We have been taking a wait and see attitude on the economy, and business conditions have been weak," Herman Halim, President of Bank Maspion and the East Java chapter of the Private Banking Association (Perbanas) said. "However, unlike the first quarter, we are seeing increased business activity in April. There is a sign of light," he added. Halim still does not foresee significant increases in credit this year, adding, "We are having a hard time finding good customers and plan to maintain our strict underwriting standards." Halim feels pressure for credit growth from BIS but commented ruefully, "I would feel a lot more pressure from my bosses if the bank's performance drops."

17. (SBU) According to Abdul Mongid, head of research at the  
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Pembanas Institute in Surabaya (which trains many of the tellers and junior bankers entering East Java Banks), the owners of the nine Surabaya based CCBs are close friends and rarely compete directly with one another for customers. "Their account officers move up and down value chains to find new business. They do business with their existing customers' suppliers and customers. They do not work with walk-in customers not referred by existing customers," stated Mongid. Mongid thought that the owners of the undercapitalized banks would all inject equity into their banks to avoid a forced merger, because owning a bank is a status symbol in the business community.

18. (SBU) East Java bank owners mention liquidity management and the ability to move money around as reasons for bank ownership. A director of the Surabaya-based Wings Group, the largest domestic manufacturer of soap products and owner of Bank Ekonomi (a Jakarta-based bank), disagreed with Mongid that status was a primary motivation for bank owners. He explained, "We keep our bank as a liquidity management vehicle. We deposit our profits in the bank, which can then be lent or invested domestically or internationally. We are not concerned that the bank be terribly profitable, only that it does not lose money." He explained the importance to ethnic Chinese East Javanese of maintaining liquidity and flexibility with their investable funds as a hedge against local instability. Andry Wijaya, Director of Bank ANK, (a Surabaya-based bank currently under the minimum capital requirement) noted that, "We feel no pressure to grow and we will wire funds in whatever amount BIS requires to stay independent before the deadline." Surabaya banks remain very liquid, ending 2005 with a very conservative 52.8 percent loan-to-deposit (LDR) ratio, which further reduced to 46.2 percent at the end of March 2006. The high interest rates are attracting deposits into local banks faster than they can make prudent loans, according to Widjaya.

East Java's Largest Bank Taking Things Slow  
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19. (SBU) The head of Bank Jatim has his own thoughts on credit growth and does not feel compelled to bend to the wishes of Bank of Indonesia - Surabaya (BIS). Bank Jatim (short for Java Timur or East Java), headquartered in Surabaya, is the largest East Java-based bank. The East Java Provincial Government and each of the province's 39 city and regency governments own Bank Jatim in partnership. The Bank's primary mission is economic development in East Java. All funds distributed by the central government to East Java government entities flow through Bank Jatim, and all provincial, regency and city employee salary payments are made to Bank Jatim accounts. According to Bank Jatim Managing Director Agus Sulaksono, the bank makes a variety of types of loans but specializes in construction lending to contractors building government projects such as roads or schools. They also carry a large portfolio of small and medium enterprise (SME) loans, generally structured and revolving lines of credit secured by real estate, with loan-to-value ratios generally under 70 percent. Bank Jatim is also a primary small agriculture lender in the province and a large purchaser of development loan syndications from other provincial development banks. The bank charges interest rates of 12 to 18 percent per annum on its business loans, significantly less than competing private institutions. Bank Jatim is notoriously conservative with its underwriting, reserving its inexpensive, government-subsidized loan funds for only the safest lending opportunities. This is reflected in its 1.25 percent NPL ratio, well below the national average of 8.9 percent at year-end 2005.

110. (SBU) As Sulaksono noted about his bank's reputation for risk aversion, "Why should I take any risk? I must now

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personally guarantee all of the deposits in this bank to the Indonesian Deposit Insurance Company (LPS) and I retire in two years. We play it straight here, unlike some other banks. So I do not have large foreign bank accounts to fall back on like some of my counterparts (at other government-owned banks). I can not afford to risk my retirement by making imprudent loans." From his analysis of credit card receipts from business banking customers and increasing NPLs, Sulaksono sees the East Java economy slowing. He projects Bank Jatim NPLs will increase to 3 to 4 percent this year. He feels 5 to 10 percent loan growth at Bank Jatim in 2006 would be aggressive by the bank's standards, and seemed comfortable dismissing BIS efforts to push for higher loan growth. Sulaksono noted that the goals set for Bank Jatim by its local government owners for safety and profitability were his primary decision-making factor, not BIS policies.

#### Small Banks Facing Increased Competition

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111. (SBU) There are roughly 360 small, privately owned rural credit banks (BPRs) in East Java, most located outside of Surabaya in small cities and villages. BIS regulates all BPRs in East Java. BPRs hold 2.7 percent of East Java bank loans and, according to 2005 BIS statistics, provided approximately 25 percent of all micro credit loans in the province, making BPRs an important source of seed capital for new business development. BPRs focus on micro-business lending as well as micro-agricultural lending, using a collateralized fixed rate term loan product. Interest rates range from 36 to 42 percent per annum. Pompong Setiadi, head of the East Java BPR Association said the big competitive advantage BPRs have over Bank Rakyat Indonesia (BRI), a large national bank with extensive branching, or Bank Jatim in East Java is underwriting flexibility and the ability to respond quickly to loan requests. BPRs can grow with their customers more effectively than BRI but tend to avoid management-intensive loan products like revolving lines of credit because they

lack trained commercial lenders. BPRs are forced to charge higher interest rates to borrowers due to high overhead costs, averaging 7 to 12 percent of total assets per annum, and generally higher credit losses. The higher rate structure and high leverage (110 percent average LDR) of BPRs make them particularly susceptible to new, better capitalized and managed competitors, such as Bank Danamon Simpan Pinjam (Bank Danamon). Bank Danamon is expanding rapidly in East Java opening hundreds of marketplace based micro-branches in the province, directly competing with BPRs (Ref A). Bank Danamon offers lower interest rates, better service and a greater ability to use non-traditional collateral to secure its micro loans.

#### Small Rural Banks Feeling the Pinch

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¶12. (SBU) The quick rise of Bank Danamon and the emergence of non-regulated thrifts in East Java is having a direct and immediate negative impact on East Java BPRs ability to retain good customers and experienced lenders. Setiadi from the BPR Association admitted that the growth of Bank Danamon has hurt BPR business prospects. "Our interest margins are shrinking due to the increased competition, the loss of experienced lenders is a problem and some of our weaker members will not survive", he said. In January 2006, BIS announced that no new BPR licenses would be issued in East Java; the instruction ran counter to Bank Indonesia's strategy of increasing the number of BPRs nationally. BIS privately disclosed that East Java BPRs are experiencing significant growth in NPLs, increasing over 20 percent to 8.3 percent during the first two months of 2006. According to BIS, dozens of East Java BPRs are experiencing NPL ratios over 15 percent and total deposits

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in East Java BPRs also shrank by over 7 percent during 2005, reflecting depositor's perception of increasing risk at these institutions. Pramasudi said that BIS is getting pressure from Bank Indonesia in Jakarta to reevaluate the freeze on BPR licenses and the policy may be reversed soon.

¶13. (SBU) BIS bank examiners are very concerned with the deteriorating condition of the BPRs, and complained that this issue is currently taking up much of their time. Pramasudi claimed that BIS is setting up work out plans for their cooperative troubled banks and closing the uncooperative ones. Year to date, five BPRs have closed in East Java; Pramasudi declined to speculate on the number of additional closures this year or the closures' impact on overall banking service in the province.

#### East Java Sharia Banking

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¶14. (SBU) According to BIS statistics, sharia banking in East Java (Ref B) is still in its infancy. During 2003, 2004 and the first quarter of 2005, East Java sharia banks and SBUs showed strong deposit and loan growth, taking market share from conventional banks. East Java sharia deposits grew from less than a 0.3 percent market share at the end of 2003 to 0.7 percent at year-end 2004 and 0.9 percent in March 2005. The increasing interest rates in 2005 rates flattened the growth in East Java sharia deposits, which ended 2005 at the same 0.9 percent market share with a 26 percent jump in new deposits during the last few days of the year. BIS was unable to explain the source of the year-end burst of sharia deposit activity. LDRs for East Java sharia banks remain very high at an average 95 percent. Most assets are concentrated in collateralized fixed payment loans to consumers. To date, sharia banks and sharia banking units in East Java have demonstrated a greater ability to attract and retain borrowing clients than depositors.

Conclusion

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¶15. (SBU) Both corporate and banking contacts have expressed concern with local economic prospects. Credit contraction signals BIS's inability to force credit growth in the province through persuasive means. East Java bankers seem content to stay liquid, observing economic trends and resisting pressure to rapidly expand loan portfolios. These conservative East Java bankers seem unlikely to be persuaded by further Bank Indonesia pressure to ease underwriting standards and grow credit if they feel it will risk the integrity of their balance sheets. The recent 25 basis point reduction in Bank Indonesia base rate will have little or no impact on stimulating the economy, according to local bankers who called for larger rate decreases to avoid further economic slowing. If East Java bank behavior is indicative of the rest of Indonesian banks; Bank Indonesia will need to look at other tools, like further base interest rate reductions, to stimulate growth.

PASCOE